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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN JOSE WATER COMPANY (U 168 W) for an Order Approving the Sale of the Main Office under Section 851 and Authorizing the Investment of the Sale Proceeds under Section 790.	Application 07-01-035 (Filed January 22, 2007)

REPLY BRIEF
OF THE DIVISION OF RATEPAYER ADVOCATES

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Pursuant to the briefing schedule established by Administrative Law Judge ("ALJ") Smith during hearings held in the above-captioned proceeding, the Division of Ratepayer Advocates ("DRA") hereby submits its Reply Brief.

I. FINANCIAL ANALYSIS

In presenting any financial analysis for various alternatives, the most important part of an analysis is the rate impact on ratepayers because the Commission is entrusted with ensuring that utilities make prudent decisions in providing their services, that ratepayers are protected from unnecessary rate increases, and that all rate increases are justified and reasonable.

A. SJWC'S Cash Flow Analysis Did Not Consider The Impact on Ratepayers

San Jose Water Company ("SJWC") criticizes DRA for considering the revenue requirement associated with this transaction and states that "[the discounted cash flow analysis, not revenue requirement, is the proper and accepted methodology to evaluate the financial feasibility of each real estate option." (SJWC's Opening Brief, p. 13) However, SJWC's cash flow study fails to consider how the transaction would affect customer rates. For example, SJWC's expert witness Elliot Stein testified during hearings

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that “revenues from ratepayers were deliberately excluded from the cash flow analysis.” (Transcript Vol 2, p. 180; SJWC’s Exh. 4, p. 3) He also testified at hearings that he did not factor in revenues from ratepayers when he evaluated all three alternatives. (Transcript Vol. 2, p. 180) Mr. Stein never worked with SJWC or other utilities before this proceeding and he does not normally testify on behalf of utilities. (Transcript Vol. 2, p. 181) He does not seem to understand that revenue streams change with changes in expenses and rate base. In this case, the revenue streams collected from ratepayers would be different for Base Case, Alternative 1 and Alternative 2. SJWC’s failure to consider these differences invalidates its cash flow analysis.

SJWC’s Discounted Cash Flow /Net Present Value (DCF/NPV) analysis is also flawed because it is limited to SJWC’s shareholders’ perspective. In Alternative 2, for example, SJWC assumed that shareholders would get the proceeds ($14.98 million) from the sale of the new Main Office building after 35 years. (SJWC Exh. 1, Stein (Exh. 12) p. 36) The company then reduced the NPV of cash flows for Alternative 2 for the resale value of the new Main Office building at the end of a 35 year life. SJWC’s proposal to assign all of the proceeds to shareholders from the sale of the Main Office would deny any benefits from the gain on sale to its ratepayers.

DRA’s revenue requirement analysis considers how the different alternatives would affect customer rates. The revenue requirements associated with each alternative should be the determining factor in choosing the best alternative since this ensures that any rate increases attributable to SJWC’s space expansion is properly justified in terms of least cost analysis.

SJWC’s cash flow analysis did not considerer how its proposed alternatives would affect its customers. Therefore, the Commission should reject SJWC’s methodology because it does not analyze the effect on ratepayers and should not be relied on to evaluate the least cost alternative for ratepayers.

B. SJWC'S Claim That Alternative 2 Is The Least Cost Option For Ratepayers Is False

SJWC did not compare the revenue requirements associated with Base Case, Alternative 1 and Alternative 2, or the effect of those revenue requirements on ratepayers, over the life of the buildings. Instead, SJWC only calculated the revenue requirements for Alternative 2 and determined that it would need a $1.8708 million annual rate increase from its customers for the expense increase and return on rate base associated with Alternative 2 during the first year. (SJWC Exh. 1, Jensen p. 4)

As DRA has pointed out, that SJWC's revenue requirement analysis has four material errors: (1) it uses the wrong Net-to-Gross multiplier; (2) it took depreciation on net plant after depreciation; (3) it did not consider deferred taxes that would be available from the 1031 exchange between itself and its affiliate San Jose Land Company (SJLC); and (4) it failed to escalate lease payments for the new downtown Main Office building and the 1265 Bascom Avenue building after the 10th year. (DRA's Opening Brief, pp. 7-10)

SJWC should have compared the NPV of revenue requirements for Base Case, Alternative 1 and Alternative 2 over the life of the projects and then selected the alternative that produced the lowest overall revenue requirement for ratepayers. (DRA Exh. 1, p. 13) When SJWC prepared a revenue requirement analysis from the ratepayers' perspective, the analysis showed that the Base Case is the least cost option for ratepayers and the best solution to SJWC's space problems. (DRA Opening Brief, pp. 10-11; DRA Exh. 8, Attachment A)

Therefore, SJWC's application should be denied and the Commission should order SJWC to either renovate the Main Office or find a less costly option.

C. SJWC's Claim That The Rate Increase of $1.8 Million Under Alternative 2 Is Small Is Misleading

SJWC also claims that the proposed annual rate increase of $1.8 million is small because it represents a 1.1% increase in rates. (SJWC Opening Brief, p.15) This is misleading because the rate increase would continue over 40 years - the life of the buildings. The present value of this option with the purchase of the Chicago Title Insurance building, is $16.40 million. (DRA Exh. 2, p.15)

D. DRA's Revenue Requirement Analysis Is Sound

SJWC states that DRA engaged in a "Cafeteria style" evaluation, selecting certain aspects of Base Case, Alternative 1, and Alternative 2 to include in its financial analysis without paying attention to the consistency of such choices. (SJWC Opening Brief, p. 13.) This statement is incorrect. In fact, DRA kept all the assumptions for the three alternatives the same for the revenue requirement analysis so that the Commission can see which alternative is the least costly alternative to ratepayers by comparing the NPV of the revenue requirements. The only changes made to the SJWC's revenue requirement analysis by DRA for the three alternatives are the corrections for the four errors SJWC's witness Palle Jensen made in his revenue analysis noted above. (DRA Exh. 10, SJWC's Response 3; DRA Opening Brief, pp. 7-10)[1] This revenue requirement analysis shows that Base Case is the least cost alternative and Alternative 2 is the most expensive alternative among the three alternatives. (DRA Exh. 2, p. 14)

Aside from the financial analysis of the three alternatives, DRA also evaluated other options available to SJWC which cost less than Base Case. For example SJWC has expanded its construction of its storage space at 2264 Will Wool Drive building from its original 6,000 square feet (sf) to 9,000 sf and plans to use the additional 3,000 sf to move the materials stored at the 1251 Bascom Avenue building. This frees up 2,850 sf of space for employees in the 1251 Bascom Avenue building and reduces the additional space that needs to be leased on the first floor of 1265 Bascom Avenue Building to 1,130 sf. (DRA Opening Brief, p. 13.)

[1] All references to "Response" refer to SJWC's responses to Data Requests from DRA that are contained in a DRA Exhibit.

E. SJWC's Claim That DRA Failed To Consider Differences In Cost Per Square Foot Regarding The Alternatives Is False

SJWC's witness Stein, in his rebuttal testimony, states that DRA failed to consider differences in total sf across the options. (SJWC Exh. 4, p. 2) This statement is incorrect because DRA did not change the square footage or other assumptions provided to it by SJWC. (DRA Exh. 10, SJWC's Response 3) Since SJWC cannot buy the new building on a square foot by square foot basis, comparing the cost per square foot of the various alternatives is meaningless.

F. DRA's Revenue Requirement Analysis Of Alternative 2 Included Both \$3.8 Million And \$6.7 Million As The Purchase Price Of The New Main Office Building

SJWC states that DRA included \$6.7 in its analysis of Alternative 2, despite the fact that it claims it will only seek \$3.8 million in rate base. (SJWC Opening Brief, p. 14) DRA's revenue requirement analysis included both \$3.8 million and \$ 6.7 million. The result shows that the NPV of Alternative 2 with the \$3.8 million for the new building is 12.36 million and the NPV for \$6.7 million is 16.40 million. (DRA Exh. 3)

II. SPACE REQUIREMENTS

A. The Main Office Is Still Necessary And Useful

DRA field inspections in April 2007 and November 2007 revealed that SJWC's Main Office is in good condition and can continue to be used for many years. The historical designation makes external modifications of the building difficult, but internal modifications could be made, if necessary. (Transcript Vol 1, pp. 64) The Main Office already has access for disabled persons and other ADA requirements are grandfathered. (Transcript Vol. 1, p. 65-66) SJWC has not provided any evidence that the Main Office is in violation of any city or county building codes, ordinances, or other regulations.

As a part of developing its Base Case, SJWC hired Garden City Construction to evaluate the Main Office for a possible renovation. (SJWC Exh. 1, Stein p. 4) Garden City Construction prepared an estimated construction cost of \$3.4 million for all the required renovations, including the renovations required to meet ADA requirements, seismic upgrade, and associated electrical, heating and ventilation upgrades. Any renovations would meet current standards. SJWC's consultant, Elliot Stein, used these construction costs to develop SJWC's Base Case for its DCF/NPV analysis. Therefore, SJWC's claim that renovation of its Main Office (Base Case) is not possible directly contradicts its own consultant's findings.

As DRA proved in hearings, cramped quarters at the Main Office could be easily resolved by leasing additional space in the 1265 Bascom Avenue building, as proposed in Base Case, and/or by moving employees to the space that will be freed up in the 1251 Bascom Avenue building, or by a combination of the two.

B. Base Case Is A Feasible Option

SJWC alleges in its Opening Brief that "there is absolutely no room for future growth" in its existing Main Office (SJWC Opening Brief, p. 2), that renovation of the Main Office was completely infeasible (SJWC's Opening Brief, p. 9), and that "the Main Office and Bascom Avenue campus buildings are fully occupied and have no office space available." (SJWC's Opening Brief, p. 9) Thus, SJWC states that it legitimately ruled out renovating and remodeling the Main Office as a possible solution to its office space needs. (SJWC's Opening Brief, p. 11)

This raises the question of why SJWC proposed an allegedly infeasible Base Case as one of its alternatives in its application if it indeed is not possible. SJWC also states that its Main Office's historical status "prohibits the construction of internal and external modifications." (SJWC Opening Brief, p. 9) However, SJWC's own witness testified during hearings that some internal modifications were possible. (Transcript Vol. 1, p. 64; Transcript Vol. 2, p. 160) and that the American with Disabilities Act's (ADA) requirements were grandfathered. (Transcript Vol. 1, pp. 65-66)

SJWC's allegations are inconsistent with its own testimony. In Base Case, SJWC proposed leasing 3,980 sf of space on the first floor of the 1265 Bascom Avenue building. (SJWC Exhibit 1, Stein p. 3) The total square footage available on the first floor is 10,000 sf (Transcript Vol. 1, p. 82; DRA Exhibit 7, p. 3) In addition, separate and apart from Base Case, SJWC testified unequivocally that it intends to move items in storage from its 1251 Bascom Avenue building to its Will Wool Drive building thereby freeing up 2,850 sf of space for employees in the 1251 Bascom Avenue building. (Transcript Vol. 1, p. 68) SJWC has also testified that it plans to move its IT staff from its Main Office to 1251 Bascom Avenue as well. (Transcript Vol. 2, p. 167) Thus, both 1265 Bascom Avenue and 1251 Bascom Avenue are not fully occupied.

DRA points out that even without remodeling the Main Office under Base Case, SJWC could move some of its Main Office employees to the space SJWC proposed to lease on the first floor of the 1265 Bascom Avenue building under Base Case thereby alleviating cramped quarters at the Main Office.

C. DRA Is Not Prohibited From Considering Modifications of Options Involving Base Case And Available Space at 1251 Bascom Avenue

SJWC alleges that DRA engages in a "cafeteria style" evaluation, selecting certain aspects of Base Case, Alternative 1 and Alternative 2 to include in its financial analysis. (SJWC's Opening Brief, p. 13) Specifically, SJWC states that "DRA used the Base Case assumption that the Main Office can be renovated to increase space, in conjunction with the Alternative 1 assumption that 1251 Bascom will be renovated to increase available space." SJWC states that "[i]t is clear that in Base Case, the 1251 Bascom facilities remain unchanged." (SJWC's Opening Brief, p. 13)

This is simply not true. DRA made it very clear during hearings that it understood that the 2,850 sf of space that will become available at the 1251 Bascom Avenue building is separate and apart from Base Case. (Transcript Vol. 1, p. 67) Moreover, SJWC's witness Craig Giordano testified that it will go forward with acquiring the additional space at 1251 Bascom Avenue regardless of what alternative is approved. (Transcript Vol. 1, p. 68, 81)

SJWC's assertions imply that DRA is prohibited from analyzing whether, in conjunction with Base Case, the additional 2,850 sf of space would solve SJWC's needs. In fact, if DRA had not performed this analysis it would have done an incomplete evaluation. DRA's analysis of Base Case, coupled with the 2,850 sf of additional space that will be available for employees at 1251 Bascom Avenue, shows that SJWC would actually have more space than it needs under that scenario. (DRA's Opening Brief, p. 16) DRA questions why SJWC did not include the 2,850 sf of additional office space in its Base Case analysis (SJWC Exhibit 1, Stein pp. 5-6), but did include it in Alternative 1 and Alternative 2. DRA assumes that the purpose of this exclusion was to make Base Case less attractive.

D. SJWC's Proposed Space Requirements Are Inconsistent With Historical Customer and Employee Growth

SJWC states that "[w]ith the addition of the six new positions by 2009, as approved in SJWC's last General Rate Case (GRC), plus anticipated future growth in the number of authorize employees, overcrowding in the Main Office is only going to worsen." (SJWC's Opening Brief, p. 6) SJWC makes it sound as if it has not already hired the six new employees authorized in its last GRC, but the evidence is to the contrary. Those six new authorized positions have been filled and are currently located at both the Main Office and Bascom Avenue buildings. (See DRA Opening Brief, p. 15) Specifically, three of these employees are located in the Main Office and the other three are located in 1221 and 1265 Bascom Avenue. (DRA Exhibit 4, Response 4)

In addition, SJWC plans to relocate the IT staff from the Main Office to 1251 Bascom Avenue. (Transcript Vol 2, p. 167) As a result of this action, an additional 304.6 sf plus space occupied by the "programming room" will become available in the Main Office building. (Exhibit SJWC- 3, Main Building, First Floor Plans) This additional space can be easily used to alleviate the cramped quarters at SJWC's Main Office.

As DRA's expert witness Ravi Kumra pointed out during his testimony and in DRA's Opening Brief, historical employee and customer growth have been fairly level. For example, the year over year growth in customers varied from 0.03% in 2002 to 0.7% in the third quarter of 2007. The corresponding increase in employees over the corresponding time period averaged 2.1%. (See DRA's Opening Brief, p. 16) Hence, the lease of space at 1265 Bascom Avenue under Base Case and the additional 2,850 sf space

SJWC will free up at 1251 Bascom Avenue should be more than adequate for new employees and future growth. In fact, as DRA has demonstrated in its Opening Brief, SJWC really only needs to lease 1,130 sf of space at 1265 Bascom Avenue, not the proposed 3,980 under Base Case, and it would still have adequate space for current and future employee and customer growth. (DRA's Opening Brief, p. 16)

E. SJWC Violated Section 851 When It Sold Five Properties Without Commission Approval

DRA found that SJWC sold or transferred five properties without Commission approval. (DRA Exh. 1, p.16) SJWC claims that it transferred the properties to nonutility plant before the properties were sold or transferred and did not violate Section 851 of the Public Utilities Code.[2] (SJWC Opening Brief, p. 17) DRA contends that two of the properties that were sold to SJWC's affiliate SJLC could have been used for SJWC's future expansion plans including building a new Main Office in the future. (Transcript Vol. 3, p. 355)

SJWC should have filed Section 851 applications regarding all five properties it sold without Commission approval. In so doing, the Commission could also have determined whether such properties were no longer necessary and useful pursuant to Section 790 (e). SJWC made this determination regarding these five properties at its own risk. (DRA Opening Brief, pp. 19-20)

Furthermore, it appears that two properties were declared no longer used and useful after the properties were transferred to SJLC (Transcript Vol. 3, p. 326-327, DRA's Opening Brief, pp. 21-22), and that these two properties may have been in utility plant in service at the time of transfer and may not have been taken out immediately. For example, the property designated as the First Street Station property (Lot 276, APN # 412-07-017) was sold to SJLC in September 2000. However, the recommendation for removal from Utility Plant in Service was made on April 13, 2004 (Transcript Vol. 2, p. 237; DRA Exhibit 11). This was almost three and one half years after the property was

[2] All references to "Sections" are to the Public Utilities Code unless otherwise indicated.

sold to SJLC. Similarly, the property designated as the Blossom Hill Station Property (Lot 214, APN # 464-45-057) was sold to SJLC on December 1999. SJWC waited until on March 6, 2001 to recommend removing this property from Utility Plant in Service. (Transcript Vol. 2, p. 238; DRA Exhibit 11). This was almost 15 months after the property was sold to SJLC.

Contrary to SJWC's assertions regarding these properties, DRA recommends that the Commission order SJWC to file Section 851 applications for the sale of the five properties. (DRA Exh. 1, p. 16) The Commission should determine the appropriateness of these transactions under Section 851. If the Commission determines that these properties were still necessary and useful at the time of transfer, the Commission should void the transactions and fine SJWC for its violation of Section 851.

III. CONCLUSION

The Commission should adopt the recommendations made by DRA in its Opening Brief, which solve SJWC's need for additional space without harming ratepayers. SJWC's application for the sale of its Main Office, purchase of a new Main Office building, and purchase of the 1265 Bascom Avenue building in San Jose (Alternative 2) should be denied. The evidence proves that the Base Case is the least cost option for ratepayers while providing more space than is actually necessary to accommodate the six employees SJWC recently hired and will accommodate future growth. In addition, the evidence shows that SJWC will have 2,850 sf of additional space available for employees in its 1251 Bascom Avenue building after it moves items stored there to its Will Wool Drive building in San Jose.

DRA would like to reiterate its request in its Opening Brief that SJWC be subject to penalties for a Rule 1.1 violation. SJWC misled the Commission by failing to disclose the material fact that it had purchased the 1265 Bascom Avenue building as early as May 2007. DRA discovered this fact on the first day of evidentiary hearings (commencing on December 19, 2007) when SJWC's witness testified to that effect during cross-examination. SJWC had numerous opportunities to disclose this material fact to the Commission and failed to do so. SJWC's failure to disclose this material fact had a substantive effect not only on DRA's analysis, but also on what the ALJ and the Commission understood they were addressing in this proceeding. Such conduct by SJWC is misleading and undermines the integrity of the regulatory process and should be appropriately sanctioned via a Rule 1.1 violation. Penalties should be imposed to deter SJWC from engaging in this type of behavior in a future proceeding.

DRA recommends that the Commission order SJWC to file Section 851 applications for the five properties it transferred without Commission authorization to its affiliate and a third party. SJWC's failure to file Section 851 applications for these transfers is another indication of its total disregard for Commission statutes, rules, policies and procedures.

DRA trusts that the Commission will adopt the recommendations it made in its Opening Brief and act accordingly. Any other decision would be harmful to ratepayers and would reward SJWC for its lack of candor and concealing its various real estate transactions from the Commission.

Respectfully submitted,

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February 5, 2008

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of "**REPLY BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES**" in **A.07-01-035** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on February 5, 2008 at San Francisco, California.

/s/ IMELDA EUSEBIO

Imelda Eusebio

N O T I C E

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